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LET'S NOT MAKE A DEAL

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This seems to be the mindset in many civil lawsuits. Of course, the decision is not that simple. In virtually every civil lawsuit, each party must decide whether to settle the case or go to trial, a decision that rests on each party's assessment of the likely trial outcome. That assessment involves an element of risk. We tested the accuracy of those assessments--i.e., did the parties accurately assess trial outcomes vs. settlement alternatives? Our study* raises provocative questions as to why more cases do not settle once an offer is on the table.

We examined 2,054 California non-class action civil cases that were adjudicated¹ and in which there was a settlement alternative for both plaintiff and defendant. Data consisted of all cases reported in Verdict Search California from 2002 to 2005 in which the parties' attorneys agreed on the amount of the pre-trial settlement offers and the final award, i.e., there was no dispute regarding the settlement alternatives and the ultimate outcome;² approximately 20 percent of California litigation attorneys represented a party in the dataset cases. We compared parties' proposed settlement amounts with the final verdict and award to determine a) whether a party made a "decision error" in deciding to go to trial/arbitration, and b) the magnitude of the financial gain or loss, in going to trial. Decision error occurred when a party rejected a settlement offer,

went to trial, and the result was financially the same or worse than the (rejected) settlement offer. Decision error took three possible categorical values: plaintiff decision error, defendant decision error, and no decision error.

Among the 2,054 cases, the plaintiff made a decision error (i.e., received an award less than or equal to the last offer made by the defendant) in 61.2 percent of cases, and defendants made a decision error in 24.3 percent of cases. Significantly, while the defendant error rate is substantially lower, the average decision error cost was \$1.14 million, more than 26 times the average plaintiff error cost of approximately \$43,100.

Using stepwise multinomial logistic regression and bivariate analyses, we examined the relationship between decision error and a number of possible explanatory variables. It turned out that predictors describing the context of the case--case type (e.g., medical malpractice, personal injury, breach of contract, etc.), forum type (arbitration, jury trial, or bench trial), nature of damages (current, future, and punitive), and service of "Section 998 offers" by either party--were statistically significant and economically important. Interestingly, decision-making error was weakly associated with predictors describing each party (e.g., individual, corporation, etc.) and

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attorney (e.g., years of experience, gender, size of law firm, etc.).

The nature of 998 offers and the fact that the presence of one or two 998 offers was an important factor in modeling both parties' decision error rates makes this variable worthy of discussion. In California civil suits, any party can issue a Section 998 offer to their adversary up to 10 days before trial begins. If the offer is accepted, the case settles at the offer's terms and conditions. If instead, the offer is rejected and the party receiving the offer does not receive a trial outcome better than the offer, then the party receiving the 998 offer is responsible for paying some of the offering party's costs and fees.³

The presence of one or two 998 offers proved to be an important factor in modeling both parties' decision error rates. Although this cost-shifting proposal is designed to promote settlement, a 998 offer may inadvertently trigger a risk-seeking mentality in the party receiving the offer. Given the high frequency with which civil cases settle--and where 998 offers presumably served their intended purpose in successfully promoting compromises--here we may be observing that a 998 offer can have a polarizing effect on negotiations and ultimately raise error costs if the case does not settle. Serving a 998 offer reduced both the decision error and mean cost of error for the serving party but increased decision errors and expected error costs for the recipient party. Because a 998 offer reduces the serving party's decision error but increases the recipient party's decision error, *ceteris paribus*, the presence of a 998 offer always reduced the probability of "no error." The bottom line: once the stakes have been raised via a 998 offer (particularly from the defendant), it is probably best to settle.

Though our study was not the first of its kind, estimates in terms of the frequency of each party's decision error were remarkably comparable to those

reported by law professors Jeffrey Rachlinski and Samuel Gross & Kent Syverud.⁴ Despite the fact that each study's sample of cases was constructed using slightly different criteria, plaintiff decision error rates ranged from 56 to 65 percent, and defendant decision error rates ranged from 23 to 26 percent.

One key difference between our study and past research was the magnitude of the cost of a decision error, particularly for defendants. For example, using jury cases from 1981 to 1988, Rachlinski (1996) observed a mean cost of error of \$354,900, or 78 percent lower than the inflation-adjusted mean cost of error using our 2002 to 2005 data.

One may argue that perhaps our results are specific to the chosen time period. To place our results in a historical context, we also examined average demands, defendant offers and awards available in the Jury Verdicts Weekly in five-year increments from 1964 to 2004, for cases that met the same selection criteria as our 2002 to 2005 sample. It turns out that the prevalence of decision error increased somewhat over time. In 1964, plaintiff or defendant decision errors were made in 72.8 percent of cases; by 2004, at least one decision error was made in 86 percent of cases. But the cost of decision errors increased substantially--a plaintiff decision error increased from approximately \$1,200 in 1964 to \$40,800 in 2004, and the cost of a defendant's error skyrocketed from approximately \$5,900 to \$649,100. In other words, error rates have increased moderately with time, but the cost of such an error has increased substantially, particularly for defendants.

Combining the historical results with the analyses from our study and studies like ours, several alarming observations can be made. In our dataset of relatively recent cases, more than half of plaintiffs and roughly one-quarter of defendants would have been financially better off not going to trial. In many industries (such as engineering, consulting and medicine) being incorrect even 10 percent of the time

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is unacceptable, let alone 25 or 50 percent. Although there is evidence that the cost of a plaintiff decision has remained fairly constant over time since the 1980s after adjusting for inflation, the odds are clearly not in their favor once proceeding to trial. Conversely,

while decision errors are less frequent on the part of defendants, the average cost of an error has increased substantially with time. Given the rate and cost of such errors, counsel might be well advised consider the settlement alternative more carefully.

*The study was prepared by Randall Kiser, Martin Asher and Blakeley McShane and published in Journal of Empirical Legal Studies, Volume 5, Issue 3, 551-591, September 2008. Co-author Dr. Martin Asher is a special consultant to Econ One.

¹Adjudicated cases are those where the dispute was decided by a judge, jury or arbitrator.

²The objective was to construct a database of relatively homogeneous cases. To that end, we excluded cases that were decided on procedural or technical grounds prior to adjudication based on merits (e.g., summary judgment, mistrial, etc.). Also, we removed class actions because of the unique dynamics of attorney/client relationships. If either side consisted of multiple parties, and the parties' settlement positions were not sufficiently allocated, these too were eliminated. Finally, we excluded cases in which there were typographical discrepancies on the face of the report.

³Under section 998(c), if a defendant's offer is rejected and the plaintiff does not obtain a more favorable judgment, the plaintiff is not entitled to recover court costs and must pay the offering defendant's costs from the time of the offer. Under section 998(d), if a plaintiff's offer is rejected and the defendant fails to obtain a more favorable judgment, then the court may award a "reasonable sum" to account for plaintiff's incurred expenses for expert witnesses. Also, Civil Code Section 3291 provides pre-judgment 10 percent interest on plaintiff's judgment beginning on the date of the plaintiff's initial 998 offer that is less than the trial judgment.

⁴Rachlinski, Jeffrey. Gains, Losses and the Psychology of Litigation. 70 S. Cal Rev. 113 (1996); Samuel Gross & Kent Syverud. Getting to No: A Study of Settlement Negotiations and the Selection of Cases for Trial. 90 Michigan L. Rev. 319 (1991); Gross & Syverud (1996), supra.

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See Journal of Empirical Legal Studies, Volume 5, Issue 3, 551-591, September 2008 for the complete article.